

August 14, 1970

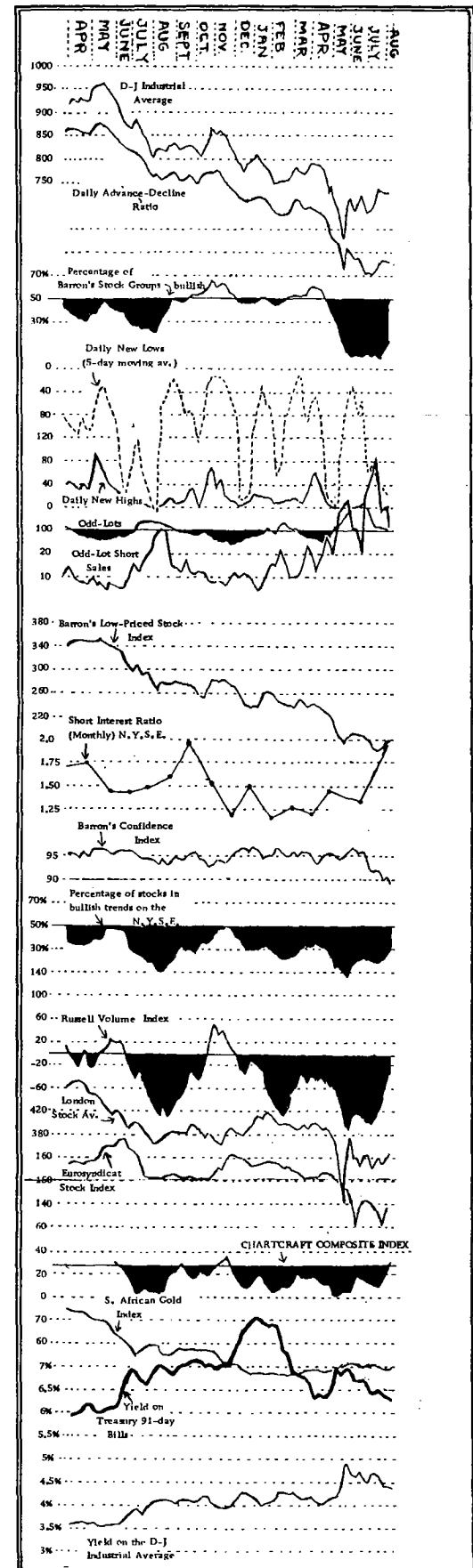
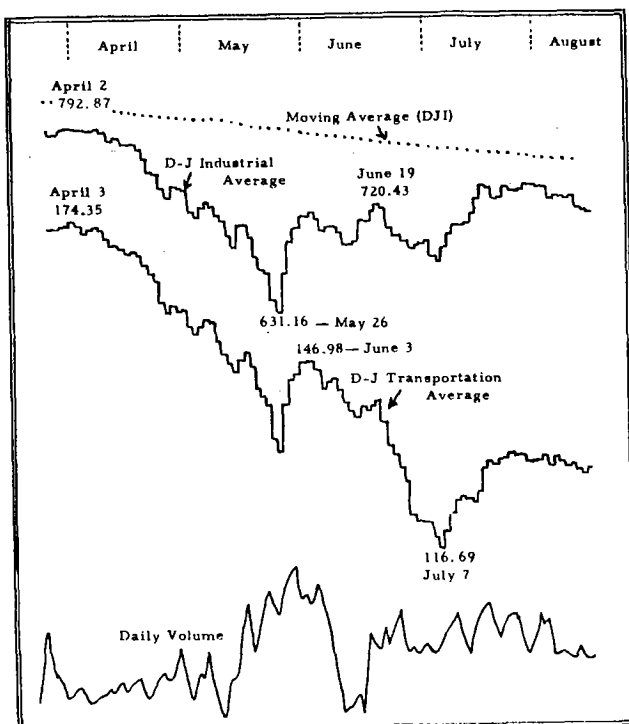
Letter 470

THE MARKET: I have been thinking alot about the big (primary) picture and the technical condition of the market. It occurs to me that most investors (and this is particularly true of technical students) do not understand the meaning of the technical condition of the market within the context of the primary trend.

The primary trend is the great overriding force or direction of the market. It is vital to remember that all major bull and bear markets undergo three distinct psychological phases (which have been discussed at length in many previous Letters) before they reach the termination or exhaustion stage.

Now, at times the technical condition (within the context of the primary trend) becomes strong, at other times it becomes weak. From the primary trend and the investment standpoint, the only time the technical position of the market is of paramount importance is during the third phase of a bull or bear market. That is the time when the primary trend is on the verge of reversal. At such times the market operator should move towards becoming fully invested (at the end of a bear market) or totally in a cash or liquid position (at the end of a bull market).

At other times, the technical position of the market may be of great interest, but it does not signify an imminent reversal of the primary trend. For instance, during 1932 the great 1929-32 bear market had obviously undergone all three phases. Liquidation had reached unprecedented heights, stocks were selling at great values, all the characteristics of the third phase of a bear market were present. When the technical condition of the market turned undeniably strong, the implication was that a new bull market was being born. The time had come to load up on stocks.



Page 2 Now let's take the situation at the May, 1970 lows. The bear market was in its second phase. None of the characteristics of a bear market's third phase were present. Volume was still high, stock yields were low (much lower than bonds), speculation was still apparent, 30 million shareholders were in the market (a new record), the low-priced stock index was still far too high, no massive distress and gloom enveloped the nation, the excesses of the 1949-66 bull market were far from being corrected.

The technical position of the market could be termed poor during May, 1970. Odd lotters had not been selling for long, odd-lot short sales were low, the short interest ratio was low, and the short interest ratio in the 30 Dow stocks was very low. However, the market appeared quite "over-sold", and the advance-decline ratio had totally collapsed, producing one of the most drastic over-solds in breadth in history. This was enough technical strength to produce a rally, and the rally carried from the low of 631 (Dow Industrials) to the late-July peak of 735.

Currently (August), the technical situation might be termed fair but confused. Odd-lots have been selling steadily, the odd-lot short sales have been high, the short interest ratios are higher. Against this, the Transports have not confirmed Industrials, Barron's Confidence Index (last week) broke below 90 for the first time since 1963, the A-D ratio has refused to confirm the rise in Industrials, daily new lows have outnumbered daily new highs on every day since the rally began.

Technically, I have termed the market's condition fair. There could be enough technical strength for an extension of the rally, or the rally could have seen its high. But the far-more-important consideration is that the bear market is still in its second phase. The third phase of the bear market is still to come. This fact alone serves to minimize the importance of the current technical situation. Those who buy here are playing merely for an extension of a secondary uptrend in a bear market, at a time when the third or final phase of the bear market has not even begun.

In a year or so or whenever the third phase of the bear market is under full sway, I will be vitally interested in the technical condition of the market. For during the third phase, I expect a period to arrive when the technical situation of the market is well nigh impregnable. When that occurs, we will be all eyes and ears. For that will signal the movement to the final bear market bottom, and probably a once-in-a-generation opportunity to buy stocks on the extreme-bargain counter. In closing I suggest that subscribers read and re-read the above discussion. It is vital to understand the foregoing if one wishes to be successful as a long-term investor.

CHANNEL: This is the point & figure chart, updated, which appeared in Letter 466. The chart (courtesy of Chartcraft, Larchmont, N.Y.) is a 5-point, 15-point reversal chart of the Dow Industrials. Each square on the chart equals 5 points on the Dow, and only rallies and declines of a full 15 points or more are shown. The X's on the chart represent rallies; the O's denote declines.

The high point at the upper left is the 985.21 peak of December, 1968. As seen on the chart, all rallies and declines since the 985.21 peak have held within the limits of a well-defined channel. So long as this is true, the over-all trend of the Dow may be considered bearish from a P & F standpoint.

An interesting characteristic of channel-movements (and this was discussed in Letter 466) is that rallies tend to touch the upper channel limits while declines tend to touch the lower channel limits. This characteristic held in force until the March, 1970 peak of 792.37 (marked "1" on the chart). Here we note that the Dow failed to touch the upper channel limits. This was followed by the 161 point drop to the May 26 low of 631.16.

At the May low, the lower channel limit was mildly penetrated. From the May low point, the Dow reversed, and by July 28 the Industrials succeeded in recovering to a peak of 735.56 (at peak "2" on the chart). But the 735.56 peak failed again to touch the upper limits of the channel. From the July 28 peak of 735.56, the Dow moved sideways. Then on August 3 the Dow suddenly broke 11.16 points. On August 4 the Dow touched an hourly reading of 717.48, and the last vertical line of O's was drawn. It was drawn because any hourly reading of 720.00 or below represented a 15 point reversal from the 735 box which represents the peak (so far) of the rally.

What happens from here? From the bullish standpoint, a reading of 740 would be required to provide an "all clear" for the secondary trend of the Dow. A figure of 740 would better the last peak of X's at point 2 on the

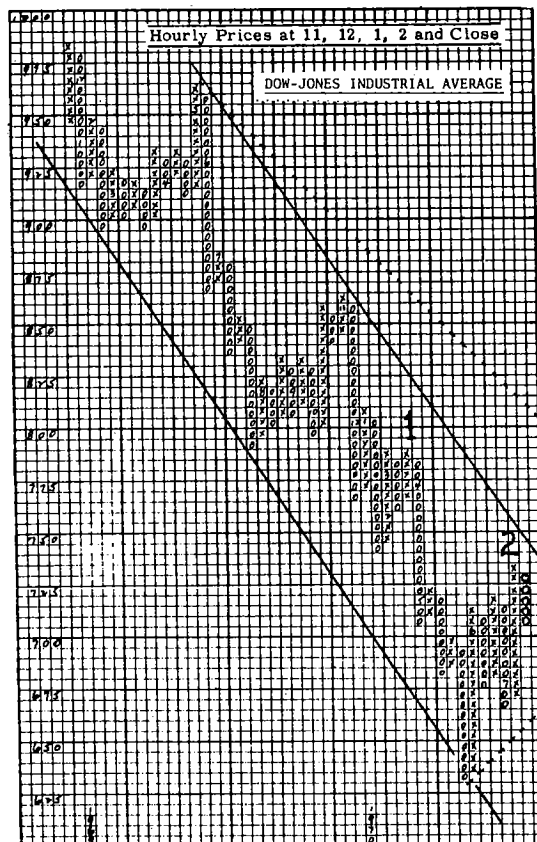


chart. On the Downside, I am watching the halfway mark of the entire rally from 631 to 735, a rally which tacked on 104 Dow points. The halfway mark of the rally is 683. Failing to hold 683, I feel that the odds would be greatly increased for a testing, and probable penetration of the bear market lows. In the meantime, I don't see any point in trying to outguess the market over the period ahead.

The leadership has been negative, with the 20 most-active stocks index (see Letter 467) plunging to minus 14 on the week ending August 7. The divergence between the Dow and the advance-decline ratio is still very much in effect (see Letter 468). The market appears to be distributing under the guise of any spate of "good news" such as the Mideast "settlement". On the other hand, the Administration, faced with a fall election, is setting up a virtual barrage of "bullish interpretations" regarding any squib of hopeful news or any miniscule up-tick in the business indicators.

In the end, I believe the forces of the bear, which are far from exhausted, will exert their tidal effect on the market, sweeping it to lower levels despite the best laid plans of Washington and Wall Street. So, I again urge my readers to exercise patience and conservatism. Stay in cash or the equivalent. If you have a business or run a business, stay liquid or get liquid. The primary bear market is not interested in politics or Administration aspirations. It is not interested in helping you or me or the funds or the fund managers. The Lord helps those who help themselves. Your job is to decide whether what I write here is valid and the truth — and then act if you have not already acted.

RUNNING WILD: It was announced a few weeks ago that the Federal deficit for the fiscal year ending June 30, 1970, was \$2.9 billion. Now all eyes turn to the budget for the fiscal year ending June 30, 1971 (the current fiscal year).

First, it is worth noting that for the fiscal year ending June, 1970, spending was up \$12.2 billion over the previous year while revenues were up only \$6 billion. It is important to realize that the \$12.2 billion rise in spending came in the face of a \$900 million cut in military spending. In other words, non-military spending rocketed \$13 billion for the year, the greatest increases in non-military spending in U.S. history.

Now to turn to the current fiscal year or the fiscal year which will end June 30, 1971. Mr. Nixon is estimating that the Government will take in \$204.3 billion and latest estimates are that the Government will spend \$205.6 billion. This would produce a "minor" deficit of \$1.3 billion.

Here's what is actually happening. The bear market is beginning to "take hold" in the corporate profit area. Already, Government estimates for corporate revenues are falling below expectations. The stock market slump is cutting very deeply into receipts which the Government thought it would receive via capital gains taxes. It is now conceded that total Government "take" may drop below \$200 billion.

On the other side of the ledge, spending has already increased \$3 billion above estimates, boosting the total projected spending figures to at least \$208.5 billion. This means that as matters now stand (barring a strong business upturn) the budget deficit coming up could be at least \$9 billion.

But the figure of a \$9 billion deficit for the current fiscal year could easily be on the low side. As seen on this little news clip, the Council of State Chambers of Commerce predicted (about one month ago) that the deficit will be around \$12.5 billion. Last week the National Observer noted that "Indeed, the President's economic advisers are busily putting down forecasts that the deficit for fiscal 1971, which began July 1, could grow to \$15 billion."

My own feeling is that the coming deficit could be considerably above \$15 billion, and I base this on the fact that we are currently in a primary bear market, a bear market that between now and June 30, 1971, will probably play havoc with corporate profits and capital gains intake by the Government. In fact, it wouldn't surprise me to see the Government's revenue fall far, far short of the "expected" \$204.3 billion or even the "pessimistic" \$200 billion. If that happens, the deficit could climb to \$20 billion and beyond.

In that case, the Government will be in the money market to make up part of the deficit. The effect will be to run interest rates near or through the roof again. On top of this, massive cuts in military and civilian spending will be called for. U.S. overseas military commitments will be cut to the bone (and of course we are already heading that way).

\$12.5 Billion U.S. Deficit Predicted

WASHINGTON (AP) — The Council of State Chambers of Commerce yesterday said the 1971 federal deficit could climb to \$12.5 billion, nearly 10 times the Nixon administration's estimate of \$1.3 billion.

A deficit exceeding \$10 billion "is not only possible but probable," the council said, on the expectation that Congress will turn down revenue-raising measures proposed by President Nixon.

Page 4 Domestic programs will have to be pared, and a giant cost-cutting effort will be instituted in the face of a gathering slump. Unemployment will surge higher, as manufacturers attempt to increase productivity while cutting costs, and the Government will be forced to follow the same route. This is the way I see the bear market moving into its final throes. It will not be a pretty sight, but it will serve to show the folly of perpetual deficit and "over-spending".

It may come as a shock to many, but corporations are even now preparing the way for a major drop-off in capital spending. Along these lines, I was particularly interested in this section from the current *Dun's* magazine. It offers dramatic evidence of the troubles and dislocations which loom ahead for 1971.

The same may be said on the defense front, and here it is certain that the Administration is attempting to cut back sharply, not only on military hardware but on troop commitments at U.S. bastions throughout the world. The results of the cutback are not going to be pleasant here either, and I thought this section of interview (from *Dun's*) with Deputy Secretary of Defense David Packard was of particular interest. It shows that the Administration is prepared for trouble, and it has already taken a "mental stand".

Meanwhile, let's turn to the action of the Federal Reserve Board under the leadership of Mr. Arthur Burns. Elliot Janeway, in his report of July 29, lays the picture on the line. "The problem in the White House is fiscal. The situation has changed a great deal since Burns left the White House for the Federal Reserve Board, but the problem has scarcely changed at all. He put it bluntly enough in his valedictory as Presidential counselor. The net of Burns' farewell last January was to warn not to expect too much from the Fed.....If the Federal Government's unfunded condition was not brought under control, he warned, the Fed.....could not improvise a cure; which is to say, monetary restraint is no substitute for lack of fiscal restraint. But once the Federal Government puts its house in order, the Burns line goes, the pieces of the monetary puzzle would gradually fall into place without the Fed being expected to solve the problem which only the Administration can solve in co-operation with Congress."

As noted previously, the Administration has hardly been solving its fiscal problems. And the Fed has not been about to solve the Administration's problems for it. There is no doubt in my mind but that Mr. Burns is very disturbed by what he sees happening on both the domestic and balance-of-payments front for the U.S. The puzzle of the Fed may be further clarified if we quote from a Burns speech made on April 23, 1968 in Los Angeles (quotes courtesy of Myer's Finance Review):

"When a nation permits its economy to become engulfed by inflation, policymakers no longer have any good choices Unless the deficit in our balance of payments is soon corrected, the new dual price system for gold will probably collapse.... In that event, we may have to choose between raising sharply the official price of gold or letting the dollar find its own value on the foreign exchange market..... Either answer would mean devaluation of the dollar.... If the price of gold is raised, the dollar will be devalued with respect to gold. On the other hand, if the dollar is allowed to float, it will be devalued with respect to other currencies, unless foreign governments choose to support the dollar..... It seems doubtful to me that our Government will practice monetary and fiscal austerity over a sufficiently long time to subdue inflationary expectations and restore full confidence in American financial policy."

To me, those quotes and the quote from Janeway provide a valuable insight into what the Fed is now doing. It seems to me that Burns does not intend to bail the Government out of its fiscal mess via inflationary Federal Reserve policies. It seems to me that

All members of DUN's Presidents' Panel, these top corporate executives across the country have put it on the line: industry is drastically cutting back—and the worst may be yet to come. In fact, this latest survey of the Presidents' Panel, the blue-ribbon group of 300 of the nation's top business leaders, stands as something of a milestone in economics reporting this year. For it shows, clearly and for the first time, that industry finally, after eight years of unrelenting growth and expansion, has begun to cut back sharply not only on manpower but on capital outlays—and that these cuts seem destined to continue for some time to come.

Moreover, these decisions to cut employment, shelve new plants or postpone the buying of machinery and other capital goods come from a diversity of industries.

Not too long ago, Lockheed asked the Defense Department for financial help. What happens if big contractors run short of cash. Do you bail them out?

No. Contractors can't continue to take risks that are substantially larger than their financial capability. If they accept a contract, they must deliver. To make sure they can, we are now taking a look at their financial resources. They must be able to take a loss on a contract if for any reason it should occur.

This problem is a result of the whole conglomerate movement. Companies became big just for the sake of bigness. This has troubled me. What we can do here is force contractors to go for better performance.

How?

Better performance in itself means bigger profits.

That may be true, Mr. Packard. But from a national security point of view, can the Defense Department afford to let such big contractors as Lockheed, North American Rockwell or General Dynamics go under?

It's important that we preserve the capability of the defense industry. But it doesn't follow that we have the responsibility to keep any contractor in business. Matter of fact, there is excess capacity in the defense industry this year. And in the years ahead, there will be even more. So I expect some fall-out in the defense industry.

Big or little companies?

Both.

Burns is not going to be an Administration flunkie and cover their balance-of-payments deficits and budget deficits with a new, massive flood of dollars.

LIQUIDITY: Beyond all the spending cutbacks, beyond all the unbalanced budgets, it seems to me that the single most important phenomenon today is the collapse in corporate liquidity. On August 6 the New York Reserve Bank made headlines with their statement that liquidity fears have been exaggerated. In reading past the headlines, however, I was interested to note that what the bank was saying was that the "fears" were exaggerated. They did not say that the problem itself was exaggerated.

The problem was treated with hard reality in the latest issue of the Bank Credit Analyst. Editor Donald Storey presented the

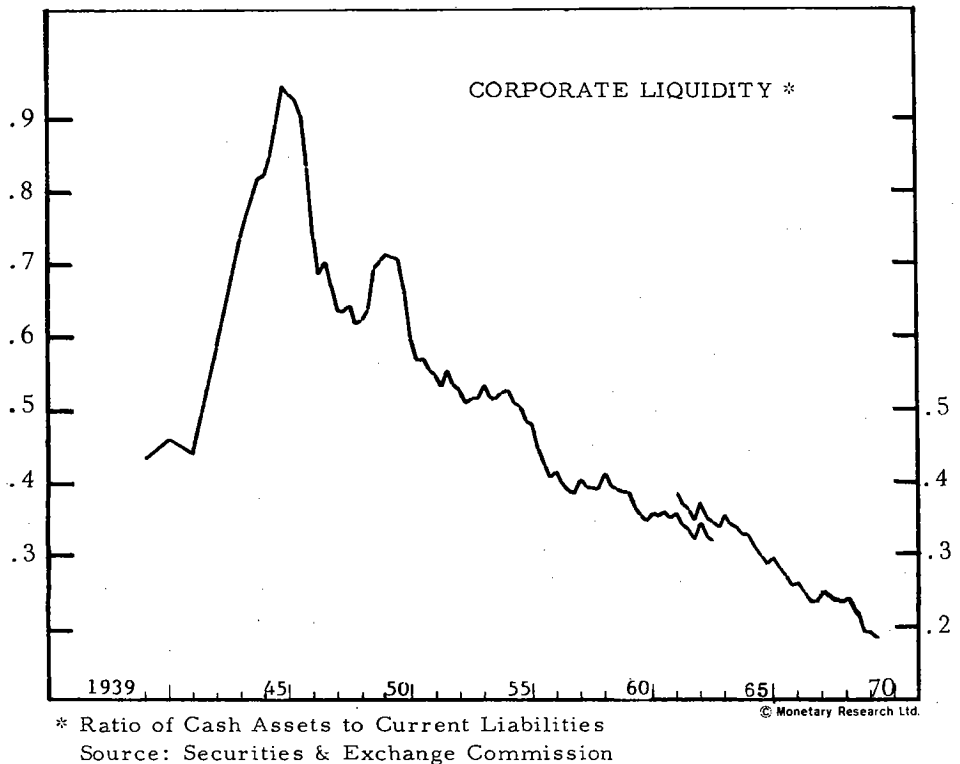
accompanying chart, showing that despite all the sighs of relief which were heard because the Penn Central bankruptcy did not set off a wave of panic, the actual fact is that total corporate liquidity is now worse than ever.

What this chart shows is the ability of manufacturing and trade corporations (reporting to the S.E.C.) to meet cash demands with their own cash resources. That ability has reached a new low since the 1930's. Storey calls it "a critical situation," and he further states that the liquidity crisis is "only beginning".

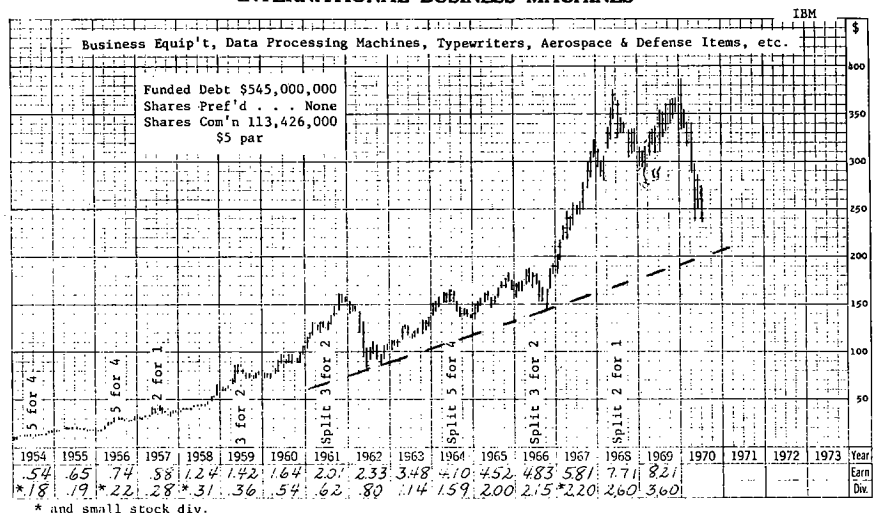
The problem is coming to a head through rising interest payments versus corporate after-tax profits. In another chart which begins in 1947, Storey shows that gross interest payments by corporations are rising rapidly while corporate after-tax profits are declining. If the trend continues, it will be only a matter of time before total interest payments absorb all after tax profits, leaving corporations with the staggering problem of paying out more in interest than they retain in profits. This situation, if it materializes, would mean the virtual wiping out of dividends across the board as corporations cut to the bone to retain cash to meet their obligations.

Storey notes that the ratio of interest payment to funds available on all companies was 21% in 1957. Today that figure is 43% (in 1929 it was 31%). In other words, 43% of all current income after taxes now goes to meet interest on debt, a fantastically high figure. To restore the healthier 1957 ratio, notes Storey, corporations would have to boost current after-tax profits to \$100 billion—which is triple the current figure!

Many readers probably wonder what can happen to produce the sort of bear market action in stocks which I expect ahead. Well, it seems to me that the above situation would produce more than



INTERNATIONAL BUSINESS MACHINES



Page 6 enough in the way of shocks and financial distress for two major bear markets. If the trends which Storey shows continue, I foresee one of the greatest financial crises in the history of this nation. As matters stand at this writing, I see nothing which suggests that the trend of falling after-tax profits and rising interest payments is being reversed. And those are some of the real fundamentals of this primary bear market.

STOCK OF THE WEEK: This week IBM, which has been a market bellwether, broke below 240 to record a new low since 1967. The monthly chart on page 5 (courtesy of M.C. Horsey, Salisbury, Md. 21801) shows this action. Note that the last major rise in IBM took the stock from the 1966 low of 145 to the 1970 high of 387, a gain of 242 points. The halfway level of this entire advance was 266. At its recent price, IBM has lost more than half the 1966 gains, and I consider such action to be long-term bearish. Based on the 50% Principle, it would not surprise me to see IBM come down to test (if not penetrate) its 1966 low of 145. This possibility would be heightened if IBM breaks 200, which corresponds to its long-term trendline as drawn on the chart (dashed line).

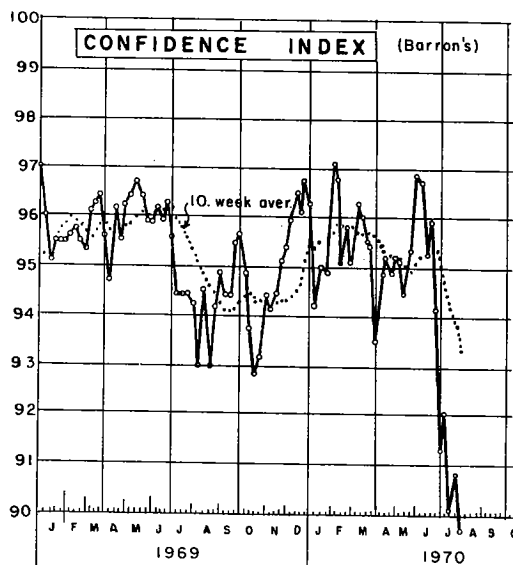


CHART OF THE WEEK: This chart of Barron's Confidence Index is courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y. 10514. The chart needs little comment, except that it is usual for the C.I. to lead the trend of the market by a month or so.

INSANITY OF THE CENTURY: If any subscriber can think of a better title for this squib from Atlas Magazine, let me know.

HISTORY: Every month I get a most interesting mimeographed letter from a gentleman who resides north of here named Bendinelli. Mr. B. wrote a very terse summary of events of the past few years, and I believe subscribers may be interested:

"This thing has been building for 40 years. Things were more or less kept in balance until about 1964. Neither the conservatives or liberals had their complete way prior to this. A pretty fair growth resulted. The best ever seen.

"AFTER the 1964 Goldwater debacle, Johnson passed all of his spending schemes, and he escalated the war at a slow and expensive pace, without trying for victory in the good old Teddy Roosevelt way. Soon the government ran short of dollars and started selling high-interest, short-term notes in large quantities to the public. The money squeeze of 1966 resulted. Now comes the fatal error. Instead of increasing the supply of goods by encouraging business, or cutting down on the excess spending, Johnson bought his way out by flooding the country with a nine % increase in the money supply. \$15 billion to be exact. This caused the present inflation. The foreign nations viewed all this with alarm and the U.S. \$ was almost devalued by them in 1968. At the last second, Johnson abdicated. This caused the foreign bankers to back off in order to see who the new president was going to be and what monetary policies were. Early in 1968, Nixon made a trip to Europe, and on his return, not one U.S. newsman asked him about the monetary upheaval. We feel that the newsmen were told not to mention this. In the interim, the foreigners have been doing quite well during our discomfiture, and the Administration has been valiantly striving to cut the inflation without causing a depression. Our view has been - and still is - that this thing is bankrupt and that the best course is to admit it, thereby throwing the blame on the preceeding administration, devalue the dollar officially, and then go after the basic causes of the inflation. So far Nixon has shown no signs of doing so, and the results seem to vindicate our judgement. i.e. This thing was too far gone to salvage in the short three years prior to the 1972 campaign. Maybe if we had 6 year terms of presidential office, it might be pulled-off, but there isn't time to make things look good for the 1972 election. What you are witnessing now is the inevitable inflation-recession-high interest-low employment symptoms resulting from the abortive Keynesian economics theories. Howzzat Professor for a bare-bones summary?

"RECENT HISTORY: Well, pumping-up the money supply by \$400 million per week hasn't had much effect so far. It seems to be only keeping up with the inflation and servicing the higher interest rate on the debt. Results? Nothing. In desperation, Nixon is forced to impose voluntary controls at first. After the Nov. elections, they probably will be made mandatory. Read any book on any inflation, and you will see that so far we haven't missed a beat towards a total classic devaluation." 'But this time it is different', you say? They always say that!"

93 NATIONS COULDN'T PAY THE PRICE: World military spending rose again in 1969. It reached a record \$200 billion. Since 1964, more than \$1 trillion has been spent for arms and armed forces. This is more than two years' income for the world's 93 developing countries.